

CALSTRS
HOW WILL YOU SPEND YOUR FUTURE?

Tax Considerations for Rollovers

INCOME TAX WITHHOLDING INFORMATION WHEN RECEIVING:

- Refunds • Defined Benefit Supplement Payments • Partial Lump-Sum Payments
- Survivor Benefits • Cash Balance Benefits •

Purpose

This notice explains how you can continue to defer federal income tax liability on your contributions in the California State Teachers' Retirement Plan (the "plan") and contains important information you will need before you decide how to receive your Plan benefits.

This notice is provided to you by the California State Teachers' Retirement System (CalSTRS) (your "plan administrator") because all or part of the payment that you will soon receive from the Plan may be eligible for rollover to a traditional IRA or an eligible employer plan. A rollover is a payment by you or a plan administrator of all or part of your benefit to another plan or IRA that allows you to continue to postpone taxation of that benefit until it is paid to you. Your payment cannot be rolled over to a Roth IRA, a SIMPLE IRA, or a Coverdell Education Savings Account (formerly known as an education IRA).

An "eligible employer plan" means a plan qualified under Section 401(a) of the Internal Revenue Code, including a Section 401(k) plan, profit-sharing plan, defined benefit plan, stock bonus plan, and money purchase plan; a Section 403(a) annuity plan; a Section 403(b) tax-sheltered annuity; and an eligible Section 457(b) plan maintained by a governmental employer (governmental Section 457 plan).

An eligible employer plan is not legally required to accept a rollover. Before you decide to roll over your payment to another employer plan, you should find out whether the plan accepts rollovers and, if so, the types of distributions it accepts as a rollover. You should also find out about any documents that are required to be completed before the receiving plan will accept a rollover. Even if a plan accepts rollovers, it might not accept rollovers of certain types of distributions, such as after-tax amounts. If this is the case, and your distribution includes after-tax amounts, you may wish instead to roll over your distribution to a traditional IRA or split your rollover amount between the employer plan in which you will participate and a traditional IRA. If an employer plan accepts your rollover, the plan may restrict subsequent distributions of the rollover amount or may require your spouse's consent for any subsequent distribution. A subsequent distribution from the plan that accepts your rollover also may be subject to different tax treatment than distributions from CalSTRS. Check with the administrator of the plan that is to receive your rollover prior to requesting a rollover.

If you have additional questions after reading this notice, you may contact the CalSTRS Public Service Office at 1-800-228-5453.

CalSTRS strongly suggests that you consult the Internal Revenue Service and the California Franchise Tax Board or a professional tax advisor before you take a payment of your benefits from your Plan.

If there is a conflict between this publication and the law, the law takes precedence.

See back cover for more information.

Summary

There are two ways you may be able to receive a plan payment that is eligible for rollover:

1. Certain payments can be made directly to a traditional IRA that you establish or to an eligible employer plan that will accept it and hold it for your benefit (“DIRECT ROLLOVER”); or
2. The payment can be PAID TO YOU.

If you choose a DIRECT ROLLOVER:

- Your payment will not be taxed in the year it is rolled over and no income tax will be withheld.
- You choose whether your payment will be made directly to your traditional IRA or to an eligible employer plan that will accept your rollover. Your payment cannot be rolled over to a Roth IRA, a SIMPLE IRA, or a Coverdell Education Savings Account because these are not traditional IRAs.
- The taxable portion of your payment will be taxed later when you receive it from the traditional IRA or the eligible employer plan. Depending on the type of plan, the later distribution may be subject to different tax treatment than it would be if you received a taxable distribution from CalSTRS.

If you choose to have a plan payment that is eligible for rollover PAID TO YOU:

- You will not receive all of the taxable amount of the payment, because the plan administrator is required to withhold 20% of that amount and forward it to the IRS as income tax withholding to be credited against your federal tax liability. CalSTRS also will withhold 6% of the taxable amount and forward it to the California Franchise Tax Board to be credited against your California tax liability unless you request not to have state withholding. Combined, 26% would be withheld. While California tax withholding is optional, federal withholding is mandatory.
- The taxable amount of your payment will be taxed in the year it is paid unless you roll it over. Under limited circumstances, you may be able to use special tax rules that could reduce the tax you owe. However, if you receive the payment before age 59½, you may have to pay an additional 10% federal and an additional 2.5% California tax for early distribution. Combined, the additional tax would be 12.5%.

The early distribution tax does not apply to distributions from a qualified retirement plan (like CalSTRS) if you separate from service in or after the year you reach age 55 even if you take a distribution before reaching age 59½. However, if you separate from service with your employer prior to age 55, the early distribution tax would apply if you take a distribution prior to age 59½.

- You can roll over all or part of the payment to your traditional IRA or to an eligible employer plan that will accept your rollover within 60 days after you receive the payment. You will not have a tax liability on the amount rolled over until you receive it from the traditional IRA or the eligible employer plan.
- If you want to roll over 100% of the payment to a traditional IRA or an eligible employer plan, *you must find other money to replace the 20% (or 26%, whichever is applicable) of the taxable portion that was withheld*. If you roll over only the 80% (or 74%) that you received, you will be taxed on the amount that was withheld and was not rolled over.

30-DAY NOTICE PERIOD

Generally, neither a direct rollover nor a payment to you can be made from the plan until at least 30 days after you receive this notice. Thus, after receiving this notice, you have at least 30 days to consider whether or not to have your distribution directly rolled over. If you do not wish to wait until this 30-day notice period ends before your election is processed, you may waive the notice period by requesting a direct rollover. Your distribution will then be processed in accordance with your election as soon as practical after it is received by CalSTRS.

More Information

I. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER

Some payments from CalSTRS are “eligible rollover distributions.” This means that they can be rolled over to a traditional IRA or to an eligible employer plan that accepts rollovers. Payments from a plan cannot be rolled over to a Roth IRA, a SIMPLE IRA, or a Coverdell Education Savings Account.

After-Tax Contributions

If you made after-tax contributions to CalSTRS, these contributions may be rolled into either a traditional IRA or to certain employer plans that accept rollovers of after-tax contributions. The following rules apply:

- a. **Rollover into a Traditional IRA.** You can roll over your after-tax contributions to a traditional IRA either directly or indirectly. CalSTRS will tell you how much of your payment is the taxable portion and how much is the after-tax portion. If you roll over after-tax contributions to a traditional IRA, it is your responsibility to keep track of, and report to the Internal Revenue Service on the applicable forms, the amount of these after-tax contributions. This will enable the nontaxable amount of any future distributions from the traditional IRA to be determined. Once you roll over your after-tax contributions to a traditional IRA, those amounts CANNOT later be rolled over to an employer plan.
- b. **Rollover into an Employer Plan.** You can roll over after-tax contributions from an employer plan that is qualified under Internal Revenue Code Section 401(a) or a Section 403(a) annuity plan to another such plan using a direct rollover if the other plan provides separate accounting for amounts rolled over, including separate accounting for the after-tax employee contributions and earnings on those contributions. You can also roll over after-tax contributions from a Section 403(b) tax-sheltered annuity to another Section 403(b) tax-sheltered annuity using a direct rollover if the other tax-sheltered annuity provides separate accounting for amounts rolled over, including separate accounting for the after-tax employee contributions and earnings on those contributions. You CANNOT roll over after-tax contributions to a governmental Section 457 plan. If you want to roll over your after-tax contributions to an employer plan that accepts these rollovers, you cannot have the after-tax contributions paid to you first. You

must instruct CalSTRS to make a direct rollover on your behalf. Also, you cannot first roll over after-tax contributions to a traditional IRA and then roll over that amount into an employer plan.

The following types of payments cannot be rolled over:

Payments Spread over Long Periods

You cannot roll over a payment if it is part of a series of equal (or almost equal) payments (“periodic payments”) that are made at least once a year and that will last for:

- your lifetime (or a period measured by your life expectancy), or
- your lifetime and your beneficiary’s lifetime (or a period measured by your joint life expectancies), or
- a period of 10 years or more.

Required Minimum Distribution

Beginning when you reach age 70½ or retire, whichever is later, a certain portion of your payment cannot be rolled over because it is a “required minimum distribution” that must be paid to you pursuant to federal law.

CalSTRS will tell you if your payment includes amounts that cannot be rolled over.

II. DIRECT ROLLOVER

A DIRECT ROLLOVER is the direct payment of the amount of your plan benefits to a traditional IRA or an eligible employer plan that will accept it. You can choose a DIRECT ROLLOVER of all or any portion of your payment that is an eligible rollover distribution, as described in Part I above. You are not taxed on any taxable portion of your payment for which you choose a DIRECT ROLLOVER until you later take it out of the traditional IRA or eligible employer plan. In addition, no income tax withholding is required for any taxable portion of your plan benefits for which you choose a DIRECT ROLLOVER. A plan is not required to let you choose a DIRECT ROLLOVER if your distributions for the year are less than \$200.

Direct Rollover to a Traditional IRA

You can open a traditional IRA to receive the direct rollover. If you choose to have your payment made directly to a traditional IRA, contact an IRA sponsor (usually a financial institution) to find out how to have your payment

made in a direct rollover to a traditional IRA at that institution. If you are unsure of how to invest your money, you can temporarily establish a traditional IRA to receive the payment. However, in choosing a traditional IRA, you may wish to make sure that the traditional IRA you choose will allow you to move all or a part of your payment to another traditional IRA at a later date, without penalties or other limitations. See IRS Publication 590, Individual Retirement Arrangements, for more information on traditional IRAs (including limits on how often you can roll over between IRAs).

Direct Rollover to a Plan

If you are employed by a new employer that has an eligible employer plan, and you want a direct rollover to that plan, ask the administrator of that plan whether it will accept your rollover. An eligible employer plan is not legally required to accept a rollover. If the employer plan accepts your rollover, the plan may impose restrictions on the circumstances under which you may later receive a distribution of the rollover amount or may require spousal consent before any subsequent distribution. Check with the administrator of that plan before making your decision. Even if your new employer's plan does not accept a rollover, you can choose a DIRECT ROLLOVER to a traditional IRA.

Direct Rollover of a Series of Payments

If you receive a payment that can be rolled over to a traditional IRA or an eligible employer plan that will accept it, and it is paid in a series of payments for less than 10 years, your choice to make or not make a DIRECT ROLLOVER for a payment will apply to all later payments in the series until you change your election. You are free to change your election for any later payment in the series.

Change in Tax Treatment Resulting from a Direct Rollover

The tax treatment of any payment from the eligible employer plan or traditional IRA receiving your DIRECT ROLLOVER might be different than if you received your benefit in a taxable distribution directly from CalSTRS. For example, if you were born before January 1, 1936, you might be entitled to ten-year averaging or capital gain treatment, as explained below. However, if you have your benefit rolled over to a Section 403(b) tax-sheltered annuity, a governmental Section 457 plan, or a traditional IRA in a DIRECT ROLLOVER, your benefit will no longer be eligible for that special treatment. See the sections

below entitled "Additional 10% Tax on Early Distributions" and "Special Tax Treatment if You Were Born before January 1, 1936."

III. PAYMENT PAID TO YOU

If your payment can be rolled over (see Part I above) and the payment is made to you in cash, it is subject to 20% federal income tax withholding on the taxable portion. California state income tax of 6% will also be withheld unless you tell CalSTRS not to withhold state tax. The payment is taxed in the year you receive it unless, within 60 days, you roll it over to a traditional IRA or an eligible employer plan that accepts rollovers. If you do not roll over the payment, special tax rules may apply.

INCOME TAX WITHHOLDING:

Mandatory Withholding

If any portion of your payment can be rolled over under Part I above and you do not elect to make a DIRECT ROLLOVER, CalSTRS is required by law to withhold 20% of the taxable amount of the payment. The withheld amount is sent to the IRS to be applied to your federal income tax liability. For example, if you can roll over a taxable payment of \$10,000, CalSTRS must withhold \$2,000 as federal income tax. In addition, CalSTRS will withhold 6% of the taxable amount and forward it to the California Franchise Tax Board to be credited against your California income tax liability unless you request that state withholding not be applied. However, when you prepare your income tax returns for the year, unless you make a rollover within 60 days (see "Sixty-Day Rollover Option" below), you must report the full \$10,000 as a taxable payment from CalSTRS. You must report \$2,000 as federal tax withheld and \$600 as state tax withheld, and the amounts withheld will be credited against any income tax you owe for the year. While federal withholding is required, you may elect not to have California tax withheld. No income tax will be withheld if your payments from CalSTRS for the year are less than \$200.

Voluntary Withholding

If any portion of your payment is taxable but cannot be rolled over as described in Part I above, the mandatory withholding rules stated above do not apply. In this case, you may elect not to have withholding apply to that portion. If you do nothing, both federal and state income

tax withholding will be taken out of this portion of your payment. To elect out of state withholding if your distribution will be made from the Defined Benefit (DB) Program, ask CalSTRS for the *Income Tax Withholding Preference Certificate*. To elect out-of-state withholding if your distribution will be made from the Cash Balance (CB) Benefit Program, ask for form CB 584.

Sixty-Day Rollover Option

If you receive a payment that could have been rolled over, you can still decide to roll over all or part of it to a traditional IRA or to an eligible employer plan that accepts rollovers. If you decide to roll over the payment, *you must contribute the amount of the payment you received to a traditional IRA or eligible employer plan within 60 days after you received the payment*. The portion of your payment that is rolled over will not be taxed until you take it out of the traditional IRA or the eligible employer plan.

You can roll over up to 100% of your eligible rollover distribution, including an amount equal to the taxable portion that was withheld. If you choose to roll over 100%, you must find other money within the 60-day period to contribute to the traditional IRA or the eligible employer plan, to replace the amount that was withheld. If you roll over only the amount of the taxable portion that you received, you will be taxed on the amount that was withheld.

Example: Assume the taxable portion of your payment that can be rolled over is \$10,000, and you choose to have it paid to you. After 20% is withheld for federal tax and 6% is withheld for California tax, you will receive \$7,400. The amount withheld (\$2,600) will be sent to the IRS and the California Franchise Tax Board as income tax withholding. Within 60 days after receiving the \$7,400, you may roll over the entire \$10,000 to a traditional IRA or an eligible employer plan. To do this, you would roll over the \$7,400 you received from CalSTRS, and you would add \$2,600 from other sources (your savings, a loan, etc.). In this case, the entire \$10,000 is not taxed until you take it out of the traditional IRA or the eligible employer plan. If you roll over the entire \$10,000, when you file your income tax return you may get a refund of part or all of the \$2,600 withheld.

If, on the other hand, you roll over only \$7,400, the \$2,600 you did not roll over will be taxed in the year it was withheld. When you file your income tax return, you may still get a refund of part of the \$2,600 withheld. However, any refund is likely to be larger if you roll over the entire \$10,000.

Additional Tax on Early Distributions

An early distribution is subject to an additional federal tax of 10% as well as an additional California tax of 2.5% of the taxable portion of the distribution if the distribution is eligible for rollover and is not rolled over. An “early distribution” is a payment made before you reach age 59½. However, payments from a qualified plan (such as CalSTRS) that are made after you separate from service with your employer if the separation from service occurs during or after the year in which you reach age 55 are not subject to an early distribution tax.

Other exceptions to the early distribution tax include the following types of payments:

- payments that are made because you retire due to disability
- payments that are made as equal (or almost equal) payments over your life or life expectancy (or, the lives of you and your beneficiary or the life expectancies of you and your beneficiary)
- dividends paid with respect to stock by an employee stock ownership plan (ESOP) as described in Section 404(k) of the Internal Revenue Code
- amounts that are paid directly to the government to satisfy a federal tax levy
- amounts that are paid to an alternate payee under a qualified domestic relations order
- payments that do not exceed the amount of your deductible medical expenses.

Refer to IRS Publication 575 and IRS Form 5329 for more information on the additional 10% federal tax.

The additional tax on early distributions will not apply to distributions from a governmental Section 457 plan, except to the extent the distribution is attributable to an amount you rolled over to that plan (adjusted for investment returns) from another type of eligible employer plan or IRA. Any amount rolled over from a governmental Section 457 plan to another type of eligible employer plan or to a traditional IRA will become subject to the additional 12.5% combined tax if it is distributed to you before you reach age 59½, unless one of the exceptions above applies.

Special Tax Treatment if You Were Born before January 1, 1936

If you receive a payment from a plan qualified under Section 401(a) or a Section 403(a) annuity plan that can be rolled over and you do not roll it over to a traditional IRA or an

eligible employer plan, the payment will be taxed in the year you receive it. However, if the payment qualifies as a “lump-sum distribution,” it may be eligible for special tax treatment. A lump-sum distribution is a payment, within one year, of your entire balance under the plan (and certain other similar plans of the employer) that is payable to you after you have reached age 59½ or because you have separated from service with your employer (or, in the case of a self-employed individual, after you have reached age 59½ or have become disabled). For a payment to be treated as a lump-sum distribution, you must have been a participant in the plan for at least five years before the year in which you received the distribution. The special tax treatment for lump-sum distributions that may be available to you is described below.

Ten-Year Averaging

If you receive a lump-sum distribution and you were born before January 1, 1936, you can make a one-time election to figure the tax on the payment by using “10-year averaging” (using 1986 tax rates). Ten-year averaging often reduces the tax you owe.

Capital Gain Treatment

If you receive a lump-sum distribution and you were born before January 1, 1936, and you were a participant in the plan before 1974, you may elect to have the part of your payment that is attributable to your pre-1974 participation in the plan taxed as long-term capital gain at a rate of 20%.

There are other limits on the special tax treatment of lump-sum distributions. For example, you can generally elect this special tax treatment only once in your lifetime, and the election applies to all lump-sum distributions that you receive in that same year. You may not elect this special tax treatment if you rolled amounts into CalSTRS from a Section 403(b) tax-sheltered annuity contract, a governmental Section 457 plan, or from an IRA not originally attributable to a qualified employer plan. If you have previously rolled over a distribution from CalSTRS, you cannot use this special averaging treatment for later payments from CalSTRS. If you roll over your payment to a traditional IRA, governmental Section 457 plan, or Section 403(b) tax-sheltered annuity, you will not be able to use special tax treatment for later payments from that IRA, plan, or annuity. Also, if you roll over only a portion of your payment to a traditional IRA, governmental

Section 457 plan, or Section 403(b) tax-sheltered annuity, this special tax treatment is not available for the rest of the payment. See IRS Form 4972 for additional information on lump sum distributions and how you elect the special tax treatment.

IV. SURVIVING SPOUSES, ALTERNATE PAYEES, AND OTHER BENEFICIARIES

In general, the rules summarized above that apply to payments to employees also apply to payments to surviving spouses of employees and to spouses or former spouses who are “alternate payees.” You are an alternate payee if your interest in the plan results from a “qualified domestic relations order,” which is an order issued by a court, usually in connection with a divorce or legal separation.

If you are a surviving spouse or an alternate payee, you may choose to have a payment that can be rolled over, as described in Part I above, paid in a DIRECT ROLLOVER to a traditional IRA or to an eligible employer plan or paid to you. If you have the payment paid to you, you can keep it or roll it over yourself to a traditional IRA or to an eligible employer plan. Thus, you have the same choices as the employee.

If you are a beneficiary other than a surviving spouse or an alternate payee, you cannot choose a direct rollover, and you cannot roll over the payment yourself.

If you are a surviving spouse, an alternate payee, or another beneficiary, your payment is generally not subject to the additional 12.5% combined federal and California tax that applies to early distributions, even if you are younger than age 59½.

If you are a surviving spouse, an alternate payee, or another beneficiary, you may be able to use the special tax treatment for lump-sum distributions as described in Part III above. If you receive a payment because of the employee’s death, you may be able to treat the payment as a lump-sum distribution if the employee met the appropriate age requirements, whether or not the employee had 5 years of participation in the plan.

HOW TO OBTAIN ADDITIONAL INFORMATION

This notice only summarizes the federal tax rules that might apply to your payment and provides limited information on California state tax rules. The rules described herein are complex and contain many conditions and exceptions that are not included in this brochure. CalSTRS strongly suggests that you consult the Internal Revenue Service and the California Franchise Tax Board or a professional tax advisor before you take a payment of your benefits from your plan. Also, you can find more specific information on the tax treatment of payments from qualified employer plans in IRS Publication 575, Pension and Annuity Income; and IRS Publication 590, Individual Retirement Arrangements. These publications are available from your local IRS office, on the IRS's Internet Web site at www.irs.gov, or by calling 1-800-TAX-FORMS.



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